

February 27 2017

# TIPTOE THROUGH THE TULIPS AND OTHER EUROPEAN OFFERINGS

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## KEY TAKEAWAYS

The fundamental case for European equities continues to strengthen, with both earnings and valuations improving.

The technical perspective on Europe is mixed, with the region doing well on an absolute basis, but still unable to outperform U.S. stocks on a consistent basis.

Political concerns, which often get expressed through currency markets, are likely to determine whether European equities begin to outperform their domestic peers.

**The case for increasing European investments is getting stronger, as we evaluate the fundamentals, valuations, and to a lesser extent the technicals.**

Throughout most of the region, we are seeing improvement in the economic data and most importantly, in corporate earnings. After a strong fourth quarter 2016 based on MSCI Europe earnings up 28%, earnings growth may be positive for the first time since 2013, albeit just barely, on a year-over-year basis. More importantly, earnings expectations for 2017 have been improving. Valuations for European stocks are relatively attractive based on forward-looking earnings estimates, though they still seem expensive based on trailing earnings. The technical picture, the last components in our investment process, is decidedly mixed. On an absolute basis, European equities appear to be close to breaking out. However, relative to U.S. stocks, European equities have stalled, at least temporarily. Much of the relative performance between U.S. and European equities will likely depend on currency markets, which in turn are likely to be largely driven by political actions in both regions.

## I LOVE PARIS (AND MADRID AND ROME) IN THE SPRINGTIME

In many parts of the country, we have not had much of a winter and are already several weeks into spring. Early season flowering trees and bushes are already in bloom; tulips cannot be far behind. Yet there is a sense of unease, that this is just too early and that a late frost could undo all the recent growth in one night. We have that same feeling about Europe. Sure, the economic fundamentals have been improving and corporate earnings are poised for their first increase since 2013.

Yet something still feels amiss. Europe has not solved many of the issues that have plagued it for almost a decade. The Greek debt crisis is still with us, though most agree it has been isolated such that a major default will not trigger a systemic crisis. Brexit—the U.K.'s plan to leave the European Union—isn't even official yet, with the two sides touting its probable impact as anything from a net positive for the U.K. to an economic apocalypse. As is nearly always the case, we suspect that the truth lies somewhere in the middle. Populism is now a major force in European politics, with three major elections this year (the Netherlands, France, and Germany), and a fourth (Italy) a possibility. The unknowns surrounding the outcomes of these events make it difficult for the markets, and LPL Research, to become too bullish on Europe just yet.

## FUNDAMENTALS ARE BLOOMING

We cannot repeat it often enough; ultimately it is corporate earnings that drive stock prices. European earnings, at least in U.S. dollar terms, had been in absolute decline for the past three years. However, strong results for corporate Europe for fourth quarter 2016 thus far (not all companies have reported earnings) are suggesting that the earnings growth drought may be over. After a strong fourth quarter, European earnings for the whole of 2016 are tracking to an increase of 1.3% over 2015, the first year of growth since 2013 [Figure 1]. Even more importantly, consensus earnings expectations for 2017 are not only strong at just over 16% growth, but have continued to rise as earnings reports come in and economic data are released in the first two months of 2017.

Overall, about 54% of European companies have had a positive earnings surprise, averaging 3.7% in the fourth quarter. Of course, growth is not uniform and there are always surprise winners and losers by country and sector. There has been an earnings turnaround in sectors typically considered highly economically cyclical, such as materials and energy.

Materials companies' earnings had a strong rebound in 2016, particularly in the fourth quarter. Energy sector earnings declined over the year, but like materials companies, posted earnings growth in the fourth quarter of 2016. However, both sectors have shown earnings disappointments; despite the growth experienced, global investors were expecting greater earnings gains for the year. Both sectors are expected to show significant earnings gains in 2017.

The financial sector is key for European equities. Financials, at about 20%, are the largest component of the major European indices. Furthermore, financials are the sector most likely to be directly impacted by the results of the Brexit negotiations, keeping in mind that the final decision on what the financial sector looks like post-Brexit is years away. However, the ability of U.K. banks to operate in the EU post-Brexit, a process referred to as "passporting," is likely to be one of the most contested provisions of the final agreement, and one with a material impact on banks and bank earnings. Thus far fourth quarter 2016 earnings growth from the financial sector has been strong on an absolute level and relative to expectations.

### 1 EUROPEAN GROWTH A CLOSE CALL FOR 2016—HIGH HOPES FOR 2017

Name	% of Companies	Earnings Growth Estimate Q4 2016	Earnings Growth Estimate 2016	Earnings Growth Estimate 2017
MSCI EAFE	77.20	30.37	2.58	14.74
MSCI Europe	64.73	27.89	1.30	16.04
MSCI Japan	98.75	33.93	6.42	14.21
MSCI EM (Emerging Markets)	45.19	28.87	17.95	14.94

Source: LPL Research, Thomson Reuters 02/24/17

Data reported as of 02/24/17

All indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

When looking at valuations, **Figure 2** shows that European stocks are cheaper than their U.S. peers based on calendar year 2017 estimates. However, emerging market equities still appear to us the most attractive both on an absolute and relative basis. We have examined a variety of forward indicators and they all yield approximately the same result. However, we have become more comfortable with using calendar year estimates, as they account for different regions having different seasonal affects.

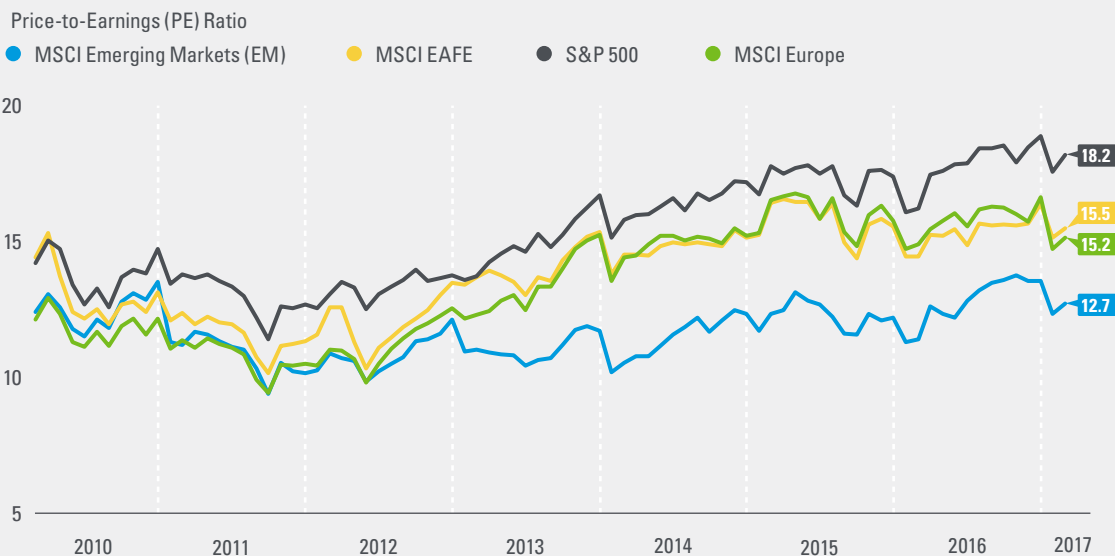
## EUROPEAN TECHNICALS IMPROVE — BUT STILL TRAIL U.S.

The STOXX Europe 600 Index represents large, mid, and small cap companies across 17 countries of the European region and is a great gauge for European equity markets. This key index has been in a steady uptrend since early 2009, finding support from this

### WHAT IS TECHNICAL ANALYSIS?

Technical analysis is a methodology for evaluating securities based on statistics generated by market activity, such as past prices, volume and momentum, and is not intended to be used as the sole mechanism for trading decisions. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns and trends. Technical analysis carries inherent risk, chief amongst which is that past performance is not indicative of future results. Technical Analysis should be used in conjunction with Fundamental Analysis within the decision making process and shall include but not be limited to the following considerations: investment thesis, suitability, expected time horizon, and operational factors, such as trading costs.

## 2 EUROPEAN VALUATIONS ATTRACTIVE, BUT EMERGING MARKETS (EM) STILL THE BEST



Source: LPL Research, Bloomberg 02/24/17

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The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

trend line once again in 2016 before a big bounce in December of last year [Figure 3].

Notably, on a much longer-term basis, the 400 level on the STOXX Europe 600 acted as resistance in 2000, 2007, and again in 2015. This is an important level and should it give way to a breakout, it could finally usher in a period of potential European outperformance. The chart is currently forming what is called an “ascending triangle pattern.” As Figure 3 shows, this technical formation has a vertical top (the 400 level) and a lower ascending trend line (the green line). Should the price breakout to the upside, it would not only be a major bullish signal for European equities, but global risk assets as well. This still has a ways to go before it happens, but the possibility of a breakout is increasing.

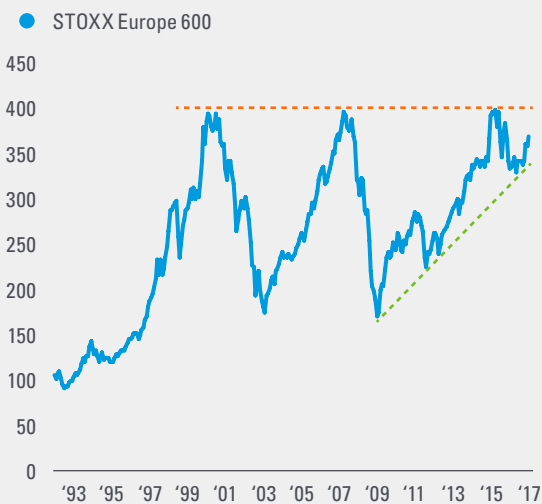
Here’s the catch: European equity markets are looking better in absolute terms, but on a relative basis they have lagged the U.S. markets since the late 1980s.

There have been periods of European outperformance, but the overall trend has clearly been in favor of U.S. equities relative to European equities.

Think about it like this, the STOXX European 600 Index is still 8% away from the peak it hit in early 2000, whereas the S&P 500 is more than 50% above its early 2000 highs. Could this mean it is finally time for Europe to outperform the U.S.? There is no easy answer here, as one could have made that argument many times over the past three decades [Figure 4], only to have been burned each time.

As Figure 4 shows, the relative performance of the STOXX Europe 600 Index has been consistently worse than the S&P 500 going back to the late 1980s. In fact, this made yet another new low recently. At the very least, to become more optimistic on Europe, we would need to see this relative strength line begin to show improvement.

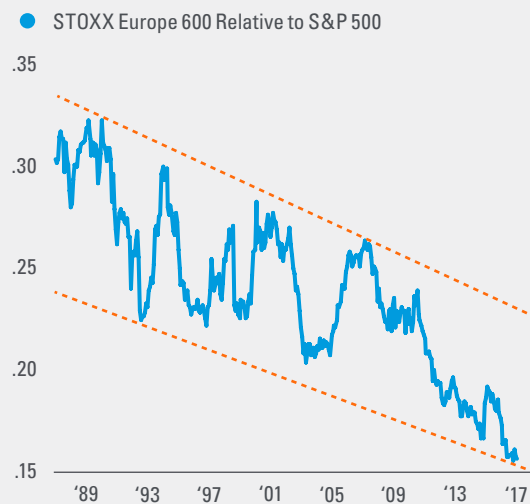
### 3 EUROPE NEARS A BULLISH TECHNICAL BREAKOUT



Source: LPL Research, FactSet 02/26/17

All indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

### 4 EUROPE HAS LAGGED THE U.S. FOR DECADES



Source: LPL Research, FactSet 02/26/17

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One positive to the underperformance is the overall sentiment backdrop on Europe is rather low. From a contrarian point of view, that could bode well for European equities should things begin to improve. For instance, a recent popular survey of global fund managers showed the euro is one of the most shorted assets globally. Also, in the popular Barron's Big Money Poll (last published in October 2016), only 14% of money managers expected European equities to outperform U.S. and emerging market equities. This is the type of extreme negativity that can be seen at major turning points.

## CONCLUSION

We see a lot to like about the coming European spring from both a fundamental and valuation perspective. The rebound in corporate earnings growth is particularly important. But market performance relative to U.S. stocks is still relatively weak, and major political events are still ahead of us. We are getting our spring wardrobe ready, but still not going to put away our winter coats. It may be time for a few modest investments in Europe for suitable investors, but we are likely to wait a bit longer before making a significant commitment. ■

*Thank you to Ryan Detrick for his contribution to this report.*

### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

All investing involves risk including loss of principal.

### INDEX DESCRIPTIONS

The MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indexes that represent developed markets outside of North America: Europe, Australasia, and the Far East.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Europe Index is a free float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe.

The MSCI Japan Index is a free float-adjusted, market capitalization-weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ, and Nagoya Stock Exchange.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The STOXX Europe 600 Index represents large, mid, and small capitalization companies across 17 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

This research material has been prepared by LPL Financial LLC.

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